

Competition, Corporate Governance, and Regulation in Central Asia

Uzbekistan's Structural Reform Challenges

Harry G. Broadman

Like many Central Asian republics, Uzbekistan has adopted a gradual, cautious approach in its transition to a market economy. It has had some success attaining macroeconomic stability, but microeconomic reforms have lagged behind. It is time to accelerate structural reform.



Summary findings

In Uzbekistan state enterprises are being changed into shareholding companies, and private enterprises account for 45 percent of all registered firms. But business decisions to set prices, output, and investment are often not market-based, nor wholly within the purview of businesses, especially those in commercial manufacturing and services.

Lines of authority for corporate governance — from state enterprises to private enterprises — are ill-defined, so there is little discipline on corporate performance and little separation between government and business.

Nascent frameworks have been created for competition policy (for firms in the commercial sector) and regulatory policy (governing utilities in the infrastructure monopoly sector). But implementation and enforcement have been hampered by old-style instruments (such as price controls) rooted in central planning, by lack of a strong independent regulatory rule-making authority, by the limited understanding of the basic concepts of competition and regulatory reform, and by weak institutional capabilities for analyzing market structure and business performance.

Based on fieldwork in Uzbekistan, Broadman recommends:

- Deepening senior policy officials' understanding of, and appreciation of the benefits from, enterprise competition and how it affects economic growth.

- Reforming competition policy institutions and legal frameworks in line with the country's goal of strengthening structural reforms and improving macroeconomic policy.

- Improving the ability of government and associated institutions to assess Uzbekistan's industrial market structure and the determinants of enterprise conduct and performance.

- Making the authority responsible for competition and regulatory policymaking into an independent agency — a "champion" of competition — answerable directly to the prime minister.

- Strengthening incentives and institutions for corporate governance and bringing them in line with international practice.

- Subjecting infrastructure monopolies to systemic competitive restructuring and unbundling, where appropriate. For other utilities, depoliticize tariff setting and implementation of regulations; ensure that price, output, and investment decisions by service suppliers are procompetitive (creating a level playing field among users); and increase transparency and accountability to the public.

This paper — a product of the Poverty Reduction and Economic Management Sector Unit, Europe and Central Asia Regional Office — is part of a larger effort in the region to assess structural reform in Central Asia. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Sandra Craig, room H4-166, telephone 202-473-3160, fax 202-522-2753, email address scraig@worldbank.org. Policy Research Working Papers are also posted on the Web at www.worldbank.org/research/workingpapers. The author may be contacted at hbroadman@worldbank.org. May 2000. (21 pages)

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

Competition, Corporate Governance and Regulation in Central Asia: Uzbekistan's Structural Reform Challenges

Harry G. Broadman*
The World Bank

* Harry G. Broadman is Lead Economist, Russia and Europe & Central Asia Regional Operations, The World Bank, 1818 H Street, NW, Washington, D.C. 20433. Author contact: hbroadman@worldbank.org. For helpful discussions and comments, the author is grateful to A. Abdukadirov, B. Abdullaev, A. Akhmedov, A. Alam, V. Anoskina, R. Guliamov, N. Mathieu, D. Pearce, S. Umarova and A. Usmanov

I. INTRODUCTION

Like most Central Asian republics, Uzbekistan has adopted a gradual and cautious approach in its transition to a market economy.¹ Although some measure of success has been achieved in attaining short-term macroeconomic stability,² microeconomic reforms have lagged behind. The policy agenda for structural reform remains formidable.

An active transformation of Uzbek state-owned enterprises (SOEs) into shareholding companies has been underway and private enterprises account for 45 percent of the total number of registered firms (where the vast majority of private firms are of small and medium scale). But business decisions to set prices, output and investment are often not market-based, nor wholly within the purview of businesses, especially those operating in the commercial manufacturing and services sectors, and this creates market distortions and misallocation of resources. Lines of authority for corporate governance are ill-defined, not only in SOEs and State "trade associations", but also in privatized firms, engendering weak external and internal disciplines on corporate performance, and little effective separation between government and business. While nascent legal frameworks for both competition policy, governing firms in the commercial sector, and regulatory policy, governing firms in the infrastructure ("utility") monopoly sector, have been created, implementation and enforcement have been hampered by the use of old-style instruments rooted in central planing (e.g., uniform market share monopoly registration, price controls, etc.), the lack of a strong independent regulatory rule-making authority, poor understanding of competition and regulatory reform concepts, and weak institutional capabilities for analysis of market structure and business performance.

The experience from other transition countries demonstrates that successfully dealing with these problems are critical for laying the structural basis for robust and enduring growth. Uzbekistan's government is cognizant of these challenges and recognizes that without effectively addressing them, there are pronounced risks that the overall economic reform program could be undermined. Indeed, one of the key items on the government's policy agenda, as part of its comprehensive program of economic reforms for the period 2000-2005, as outlined in the Cabinet of Ministers Resolution No. 296 of June 10, 1999, is to develop new structural reforms that improve Uzbekistan's competitive business environment.³

This paper—based on fieldwork in Uzbekistan—outlines recommendations for developing such a structural reform program. Six main policy challenges are identified, and the paper is organized according to those challenges: (i) concepts of competition and regulation in a market economy appear to be not well understood both by policy-makers and market participants; (ii) the formulation and implementation of competition and regulatory policies are poorly linked to the core objectives and design of the Government's overall economic reform program; (iii) the Government has developed a limited knowledge base and capacity for analysis of the country's industrial structure and determinants of a more competitive business environment; (iv) the organizational and functional independence of the Government's authority for formulating and enforcing competition and regulatory policies, as well as the system for effective checks and balances to ensure strong public transparency and accountability, are weak; (v) corporate governance incentives to instill strong competitive discipline on firms' performance and to engender effective separation between government and business, especially in state owned "associations" and related holding groups are blunted; and (vi) there is substantial scope both for competitive restructuring and unbundling of infrastructure monopolies, especially those that are not "naturally" monopolistic, and for reform of regulatory oversight of infrastructure monopoly enterprises to a strong rules-based regime.

¹ See Karimov (1998).

² See Zettelmeyer (1998).

³ For a description of the overall reform program see World Bank (1999).

Because many of the structural problems found in Uzbekistan are common with those in other Central Asian republics, the analysis presented and the policy recommendations developed in this paper are applicable beyond Uzbekistan *per se*.

II. UNDERSTANDING OF CONCEPTS OF COMPETITION AND REGULATION

Institutional Framework. Uzbekistan has made substantial progress since the advent of reform to develop an institutional framework to foster the establishment of a competitive business environment. While the framework is still evolving, to date it includes, among other measures and actions, the establishment of the Anti-Monopoly Committee (AMC), which is housed within the Ministry of Finance; development of program entitled *The Concept of State Anti-Monopoly Policy*, which formulates the main objectives of the Government's competition and regulatory policy; and enactment of several laws, such as the laws "On Competition and Restriction of Monopoly Activity in Commodity Markets", "On the Limitation of Monopolistic Activity", "On Natural Monopolies", "On Protection of Consumers' Rights", and "On Advertising".

As articulated in the *Concept of State Anti-Monopoly Policy*, the central objectives of the Government's competition and regulatory reform program—implemented by the AMC—are to develop competition and entrepreneurship in Uzbekistan's economy; regulate the activities of monopoly enterprises; prevent abuse by firms with dominant market positions; enforce sanctions on firms who engage in unfair competition; and protect consumer rights.

The nascent institutional framework and policy objectives are generally consistent with international practice. In trying to achieve the objectives, however, Uzbekistan's authorities face a key challenge: ensuring that policy officials in all key agencies and ministries (at both the national and local levels) as well as market participants—businesses (including SOEs, the Privatization Investment Funds (PIFs) and banks), consumers, workers, and the general public—both understand the basic concepts of competition and regulation, and are motivated to act in such a way as to capitalize on the role that competitive forces can play in fueling economic prosperity and growth. There are several areas where this challenge is particularly pronounced and where there is a priority for action—in particular mobilizing training, pragmatic policy advice and public education about competition and regulation.

Monopoly Register. One of the primary instruments by which the AMC implements competition policy is through its Register of Monopoly Enterprises – a policy instrument common to Russia and many other CIS countries.⁴ Uzbek enterprises that are deemed as "dominant"—defined by statute as generally having a market share of at least 65 percent, and under certain conditions a market share of at least 35 percent — are listed on AMC's Register and therefore must declare (register) their prices and profits for AMC approval. In addition, registered monopolists, once they agree with their input sellers and output buyers on volumes, delivery times, and other conditions (as well as prices) must register these transaction terms with the AMC along with their expected profits. In certain cases—typically for infrastructure ("utility") monopolies—the AMC directly determines prices and profits.

As of October 1, 1999 there were 716 enterprises and 1,924 products listed in the AMC's Monopoly Register, of which 91 enterprises and 205 products were registered as monopolies at the national (Republic) level, with the remaining (and vast majority) of monopoly firms and products registered in the AMC's 14 regional offices. Table 1 indicates the sectoral distribution of the registered monopolies. In Uzbekistan there are approximately 176,800 firms with business licenses, the vast

⁴ A description of Russia's competition policy framework is contained in Broadman (2000).

majority of which are small and medium scale. Private firms account for about 45 percent of the total number of registered businesses.

Table 1: Uzbekistan Enterprises Registered by the Anti-Monopoly Committee as Monopolies (Republic and Local Levels; as of October 1, 1999)

Sectors	Number of Enterprises	Number of Products
Bakery, grain and flour	18	40
Coal mining	5	6
Natural Gas	4	5
Food	97	551
Light industry	30	62
Local industry	11	22
Petrochemicals	8	33
Machinery	30	63
Construction materials	71	199
Furniture	16	48
Metallurgy	5	9
Services	323	690
Others	80	157
Total	716	1924

Source: Uzbekistan Anti-Monopoly Committee

Price Control vs. Monitoring. Senior management of the AMC recognizes that reliance on price and profit control is neither an efficient or desirable approach to advance competition in the commercial sectors, and that the process is creating misallocation of resources in the economy. Accordingly, as set out in *Major Strategic Measures to Improve the Operations of the AMC*, the Committee has set a goal to switch to a system of monitoring by end-2000. However, neither the AMC nor the business community has adequate capacity to appreciate fully how to make the transition to a system of monitoring and draw lessons from international experience in this regard.

Defining Economic Market Boundaries. More fundamentally, there appears to be poor understanding of and confusion about the basic concepts of competition needed to implement such a system, such as: definition of product and geographic market boundaries (allowing for economically meaningful measures of market share and dominance rather than application of statutorily defined quantitative formulae that artificially classify firms as monopolies); price and cross-elasticities to gauge market demand and product substitutability; marginal and fixed costs and their relationship to price-setting and profit maximization; seller and buyer concentration; determinants of barriers to entry and exit;

etc. The staff of the AMC, with the assistance of international experts, has been undergoing training in competition issues over the past year, and the AMC has recently developed a *Workplan for Training and Assistance* for the future that, if implemented, could help remedy some of these deficiencies.

Strategic Firms. Another key component of the AMC's program is development of plans for the "demonopolization" of certain sectors and enterprises in the Uzbekistan economy. This is a laudable objective: the competitive restructuring of many of Uzbekistan's industries should be a high priority item on the Government's reform agenda. Yet as described in the draft *Program of Formation of a Competitive Environment for 2000-2005*, tabled with the Cabinet of Ministers in late 1999, the proposed mechanisms for such restructuring are at variance with an approach based on economic concepts of competition.

Twenty-nine sectors/firms are identified as candidates for demonopolization, ranging from champagne and cognac production to backpacks and toilet soap to mayonnaise and various oil products. It is dubious that some of the sectors identified would truly qualify as strategically important for the boosting the economy's competitiveness and worth the government expending its limited resources and political capital on restructuring. Moreover, in some cases, the indicated market shares targeted for reduction are unlikely to signal monopoly power; for example, the backpack producer has a 37% market share, and the refinery producing diesel fuel and fuel oil has market shares of 20% in the former and 15% in the latter. Clearly, implementation of demonopolization is a complex endeavor for any government and must be done with great care so as to not engender new distortions in the economy. In this regard, there is a need for further articulation of Uzbekistan's demonopolization strategy and the mechanisms used for its implementation.

Competition Legislation. Improvements of the existing legislative framework for competition and regulatory policy are also needed, and this is recognized by the AMC as a priority area for reform. The Committee has identified, with the assistance of international experts, several areas where amendments or new legislation are needed, including demonopolization in commodity markets, anti-collusion measures, shareholder and property rights protection, rate-setting for regulated utility monopolies, false advertising, and consumer rights protection. In this context, the use of legislative concepts from international experience could be extremely useful in legislative drafting. Equally important, success in passage and implementation of any new legislation in this area will be greatly furthered by a deeper understanding of such concepts by members of the legislature and the affected groups—businesses, workers and consumers. Accordingly outreach and education efforts along these lines should thus be developed.

Public Education and Outreach. More generally, non-governmental organizations (NGOs) could play an important role in public education about the benefits of competition in furthering Uzbekistan's economic development. As in other countries, establishment of independent non-profit "competition education" foundations, which would be perceived by society as non-partisan, could leverage the Government's own public outreach efforts. In some countries, such groups have also taken on an ombudsman role, providing a very effective neutral vehicle for airing consumers' complaints about business violations, corruption and inefficiencies in government programs. Such a process can instill greater "ownership" by the population of market reforms and help motivate their acceptance and behavioral change.

III. LINKING COMPETITION POLICY TO THE STRUCTURAL REFORM PROGRAM

Fostering an improved business environment in Uzbekistan is a core objective of the authorities' economic reform program. Yet to date, competition and regulatory policies and the specific goals they are designed to achieve, have not been fully incorporated within the Government's broader structural and

macroeconomic reform programs; nor at the same time have the development and implementation of these other reform objectives been adequately informed by the market-oriented goals of enhancing competitive forces.

Removing Barriers to New Entrants and Restructuring Incumbents. In general, the emphasis of the existing competition policy regime has focused on dealing with the regulation of incumbent firms. But as part of the broader objectives of encouraging structural reform and the transition to a market system, a greater orientation is needed towards generating growth through the formation of new enterprises, not just via privatization of existing SOEs, but more importantly, through “greenfield” entry of new start-ups—both domestic investors and foreign investors. The experience of many other transition economies suggests that new entrants, particularly small and medium enterprises (SMEs), are the engines of growth and job creation. In Uzbekistan, recent surveys suggest that potential new businesses face substantial administrative and policy barriers to entry, including elaborate licensing requirements at both the national and local levels; impeded access to foreign exchange; difficulty in arranging for financing from banks or other sources; arbitrary and burdensome taxation; difficulties in arranging for product distribution, among others.⁵ Focusing on developing solutions to these problems as part of the broader structural reform agenda is critical to boosting competition.

Exit of Nonviable Firms and Hardening Budget Constraints. By the same token, relatively little policy emphasis has been directed toward facilitating bankruptcy, including where necessary, liquidation, of insolvent firms in Uzbekistan. The concerns about the potential social costs of such actions is understandable. Yet, with adequate social safety nets in place, such costs can be substantially reduced. International experience can provide to the Uzbekistan authorities important lessons about the benefits of reducing fiscal and financial subsidies to firms—“hardening budget constraints”—to engender improved corporate competitiveness from viable firms and to expose those that are no longer commercially viable. Indeed, viewed from the broader structural reform perspective, the bankruptcy process engenders important benefits: it provides for the re-channeling of productive assets bottled up in inefficient firms to new ventures where employment can be expanded and new products created. Importantly, facilitating the bankruptcy process should not be seen as simply in the purview of the government; indeed, on the contrary, the main focus should be on strengthening the legal rights of creditors in Uzbekistan. In turn this means accelerating reform of the country’s banking system to one where banks’ credit, lending and debt collection decisions are scrupulously made on the basis of commercial and risk criteria. Exacting such external discipline on the performance of firms in the real sector will go along way to fostering the competitive restructuring of Uzbekistan’s industry.

Openness to International Trade and Liberalization of Foreign Exchange. Trade and foreign exchange restrictions in Uzbekistan are pronounced. They serve to shelter noncompetitive industries from market forces and as a result encourage misallocation of resources, lost output and poor product/service quality. Restrictive trade practices, such as registration and prepayment requirements for imports and high average import tariffs, were enacted in 1997 and remain in place. State trading monopolies for cotton and gold exports, which generate approximately 40% of the country’s foreign exchange earnings, also undermine competition within the economy. At the same time, the dual exchange rate system and foreign exchange surrender requirements engender gross structural distortions in the economy. Removal of the trade and foreign exchange restrictions is widely seen as a precondition for enhancing the competitiveness of the economy and for putting Uzbekistan on a path for enduring growth. Indeed, although liberalization of the foreign exchange regime is often seen as a macroeconomic policy objective, its impacts on advancing the competitive structure of the economy are as critical. Equally important, accession to the WTO provides an important vehicle to reform the country’s trade regime and to lock-in, under international commitments, the removal of existing trade restrictions;

⁵ LaFleur (1999); AMCHAM Uzbekistan (1999).

through the prism of identifying potent reforms to instill competition within the Uzbekistan economy, WTO accession should be a clear priority for the Government.

Improving the Policy Regime for Foreign Direct Investment. Improving the legal and regulatory regime governing foreign direct investment (FDI) inflows to Uzbekistan should be seen as another important policy component of the broader structural reform program to enhance competition within the country's industrial base. FDI inflows not only mean the transfer of financial resources, but more importantly usually mean the economy is host to the transfer of advances in technology, the introduction of new products and production processes, enhancements in managerial and technical skills, and competitive pressure on domestic firms to perform more efficiently. Bringing Uzbekistan's FDI policy regime in line with international best practice would entail, among other measures that would facilitate new entry: providing for non-discriminatory, "national treatment" to foreign investors; phasing out existing trade-related investment measures (e.g., local content restrictions, export performance requirements and restrictions on use of foreign exchange); freedom for investment-related transfers (e.g., profits, royalties); binding international arbitration for investor-State disputes; and international law standards for expropriation.⁶

Industrial Policy. There is also the need for the design of country's industrial policy program to be better informed by—indeed be reconciled with—the Government's emerging competition policy objectives. While the latter is to give emphasis to greater use of market forces in the economy, the industrial policy program still bears a heavy administrative imprint and market control. To illustrate the problem, Box 1 shows how the draft *Program of Formation of a Competitive Environment for 2000-2005* formulates the plan for the competitive restructuring (or demonopolization) of the cognac sector. The plan is striking for its detail as to the seemingly engineered changes in production and market shares for the various producers in the sector. It casts strong doubt about any significant role envisioned by its drafters that market forces will play in the sector's future structure.

Box 1: Restructuring Plan for Joint Stock Company (JSC) "Khovrenko": Cognac Producer

The current (1999) market share of JSC "Khovrenko" is 41.3%. The plan is to reduce the share of the "monopolist" on domestic market down to 24-26% by the year 2005 by increasing the market shares of:

- JSC "Yangiyul" - from 18% in the year 2000 up to 20-22% in the year 2005;
- JSC "Shakhrud" - from 20% in 2000 up to 22-24% in 2005;
- JV "Bulungur" – from 13% in 2000 up to 15-18% in 2005;
- JSC "Urgench Sharobi" – from 7% in 2000 up to 8-9% in 2005.
- Increase exports of JSC "Khovrenko" from 25% in 2000 up to 30% in 2005.
- In the year 2005 JSC "Khovrenko" will be excluded from the State Registry of Monopolists since its market share will be reduced.

Source: Annex II, *Program of Formation of a Competitive Environment for 2000-2005*, Government of Uzbekistan; draft of October 1999.

⁶ See Bergsman, Broadman and Drebenstov (1999).

IV. ENHANCING ANALYTICAL CAPABILITIES

Effective economic policy formulation and implementation must be start with high quality and up-to-date economic information and analysis. Without a sound knowledge base about an economy's market structure and the determinants of firms' behavior, it is virtually impossible to design competition and regulatory policies that will have their intended impacts; in fact under such circumstances it is quite possible that best intentioned reforms could well create deleterious outcomes and worsen existing problems. Moreover, without such information, policy formulation in other economic spheres—for example, in the area of macroeconomic reform, such as gauging the price and market impacts of foreign exchange liberalization—will be made more difficult and subject to errors.

Need for More Empirical Assessments of Competition. Although improvements are underway—in particular within the Center for Economic Research, a quasi-Government think-tank partly funded by UNDP and TACIS—the existing database on the structure of Uzbekistan's industry is still rudimentary. While numerous analyses of particular commodity markets have been undertaken (as part of the monopoly registry process) relatively few major empirical studies of the systemic determinants of market power within key bottleneck sectors of the economy have been carried out.

Cross-Sectoral Analysis. In addition, cross-sectoral analyses that assess structural and behavioral linkages across industries and markets do not appear to have been undertaken: for example, how price distortions, production inefficiencies and bottlenecks in the infrastructure monopoly sectors, such as electric power, affect business performance by electric power consuming firms in the tradables sector, such as cotton ginning. Similarly there has been limited analysis of the competitive impacts of existing horizontal and vertical integration, and the extent to which current horizontal and vertical structures, especially in the 56 “associations” and holding group structures, engender economies of scale and scope. Without this integrative, economy-wide perspective, the formulation of competition and regulatory policies on a “general equilibrium” basis is very difficult and instead forces policy-makers to base decisions on only a partial view of the determinants of industrial performance in the economy.

Statutory vs. Economic Definitions of Markets. It also appears that the taxonomy of data that are collected and analyzed is determined more by statutory than economic criteria. For example, the data are usually assessed according to the 65%/35% legal classification of monopolies. Rather what is needed is analysis of data *to determine* the economic boundaries of markets (and thus firms' market shares), based on questions of product substitutability and geographic limits of total delivered product costs relative to demand.

Influence of Market Structure on Corporate Performance. Equally important, there is a lack of analysis of how conventional elements of industrial structure, such as seller concentration, barriers to entry, ownership structure, among other factors, influence the competitive conduct of firms. In this regard it would be important to know on a cross-sectional basis as well as over time, what gives rise to variations among Uzbekistan's firms in terms of price-cost margins and rates of return; product innovation and introduction of new processes; product and service quality; access to and disposition of domestic financing and earnings; incidence of foreign exchange; and export performance.

The AMC and the Center for Economic Research recognize the deficiencies in the existing knowledge base and analytical capabilities. Accordingly they have begun to develop action plans to remedy the situation. Indeed the Center for Economic Research is currently establishing a new thematic team within the organization that will focus exclusively on analysis of competition in the economy. Clearly, the knowledge-building agenda before the AMC and the Center is big, and it will take time to implement. Against the backdrop of limited human and financial resources to undertake this effort, it is important that as the action plans are further refined priorities be set. The set of issues identified above

suggests areas for priority attention. Yet even within those areas, data collection and analysis should be tailored first toward apparent “worst offenders” and where large amounts of resources in the economy are potentially at stake.

V. CREATING A COMPETITION “CHAMPION” WITHIN GOVERNMENT

The current Anti-Monopoly Committee, which was established by Presidential Decree in May 1996, is an outgrowth from the earlier Committee on Prices, which played a central role under the planned economic system. This in part explains the AMC’s reliance on price controls as a competition policy instrument. Although, as noted above, the AMC has set itself the objective of moving to a monitoring type of system in the near future, the perception by marketplace participants of the organization’s functions as a price (and other transaction terms) control agency will continue to be subject to inertia from the past.

Organizational Conflicts of Interest. This problem is compounded by the fact that the Anti-Monopoly Committee is actually part of the Ministry of Finance, with a Deputy Finance Minister serving as the AMC chairman. Housing the organization within the Finance Ministry is, again, an outgrowth of the AMC’s earlier incarnation as the Committee on Prices. Other transition economies’ competition agencies have had similar early organizational structures. But effective formulation and enforcement of competition and regulatory policies requires an agency with a cross-cutting, “honest broker” mandate. It also must be seen by all market participants—businesses, workers, consumers and the general public—as pursuing a credible non-partisan agenda. In part this means operating independent of line agencies, including the Finance Ministry, which, by definition will have an interest in increasing revenues and thus may create an appearance of a conflict of interest if it has jurisdiction over competition and regulatory policy. For the same conflict-of-interest reasons, it also means operating the competition agency independently of sectoral agencies. Indeed international experience suggests that effective competition agencies are those that operate in a de-politicized fashion and have the clout—the “teeth”—to deal with powerful vested interests, not only in the economy, but equally important on an inter-agency basis in cabinet debates.

Lack of Institutional Resources. The organizational structure of the AMC is comprised of a Republic level headquarters office in Tashkent and 14 local level branch offices located in various regions of the country. The total number of AMC staff is 414 persons, of which 55 work at the national level; in other words the vast majority of AMC officials work in the Committee’s branch offices at the local level. The large allotment of staff in the regions reflects the emphasis of the AMC’s activities at the local level. For example, in addition to its monopoly registering and price/profit control functions (described earlier), the AMC is involved in the promotion of competition in selective sectors carried out by the regional offices in concert with local governments. This includes, for example, establishing mechanisms to help ensure that public procurements at the local level are mediated through open and competitive tenders. The AMC is also involved at the local level in the promotion of specific investment projects in certain sectors or geographic areas of the country; for example, fostering banks to make credit available to SMEs.

Local Level Focus and Regulatory Capture. To be sure, the focus on strengthening competition at the local level is key, since that is where most business transactions are carried out. But by the same token, in Uzbekistan, as in other transition economies with nascent economic institutions, that is where the problem of “regulatory capture” is often most pronounced and prevalent: local authorities and business interests are often co-mingled and there are weak systems for checks and balances. However, it appears that AMC practices and interpretation of statutes and regulations is not consistent across regions and local markets. Discretion in enforcement appears to be exercised. This of course only serves to exacerbate the capture problem. Moreover, the role AMC branch offices play in promoting projects at the

local level, especially involvement in fostering bank credit lines, makes the agency vulnerable to regulatory capture, to say nothing of the fact that such activities undermine the Government's collateral objective of creating a market-oriented banking sector. Of course, local government officials themselves may be in violation of competition statutes—e.g., protecting local businesses from entry through delaying issuance of new licenses; provision of fiscal subsidies to incumbent firms; creating an nonlevel playing field regarding energy prices charged by local utilities to newcomers, etc.—and the AMC has brought charges in such cases. But without a strong, independent AMC, it will be difficult to enforce the law effectively at the local level, where the stakes are perhaps highest.

Need for an Independent Competition Policy Authority. There is a clear need to break from the past and reinvigorate the AMC as an agency independent from the Ministry of Finance, with a new mandate and “corporate culture”. There is not a single “best” model that the restructured agency should aim for. Different countries use different organizational set ups. Among other schemes, some have established a unitary independent agency that combines all competition and regulatory policy functions; some have established both an independent competition policy agency as well as an independent regulatory agency (or agencies); and some have established portions of competition policy functions within a ministry of justice as well as other portions in an independent agency; etc. But international practice does suggest a set of principles upon which a revitalized competition agency should operate. Such principles would likely include the following elements: (i) competition policy/regulatory decisions should be rules-based, judgements made in an impartial, independent fashion, and remedies devised on the merits of the case, in line with competition policy objectives; (ii) the entity's budget should be financially autonomous from other ministries; (iii) the entity head should have clear lines of authority and appointed and dismissed by only the Prime Minister, subject to strict, well-defined criteria, and/or serve for a fixed term; (iv) there should be a transparent appeals process for consumers and businesses, including public hearings; (v) the agency should have autonomous legislative authority; (vi) the agency's performance should be subject to regular public monitoring to ensure the public interest is protected; (vii) regional offices should be sufficient in number and breadth to ensure effective oversight and implementation at sub-republic level; and (viii) the agency should be staffed with adequate number of professionals with the requisite skills and technical expertise.

Clearly, reorganizing the AMC is a complex endeavor and will take time. The task should be undertaken as a deliberative process with public discussion, especially involving the major affected parties within the country. The advice of practitioners from other countries should be sought so as to learn the lessons of international experience. Nonetheless, a structure should be established that best suits Uzbekistan's own characteristics and challenges.

VI. STRENGTHENING CORPORATE GOVERNANCE INCENTIVES

A critical component for the improvement of the business environment is the institution of market-oriented incentives for corporate governance practices. In Uzbekistan sound corporate governance practices are blunted because of ill-defined corporate organizational structures and institutions, contradictory lines of authority, and weak disciplines/checks and balances, especially in the management of State assets. Although Uzbekistan has enacted a Company Law, in practice the structure of the modern corporation has not yet been widely adopted in the country. Uzbekistan's approach to corporate governance—particularly in the key firms, which still have heavily state involvement—shares many similarities with China, Russia and other transition economies.⁷

⁷ China's state asset management approach to corporate governance is described in Broadman (1999) and World Bank (1997); Russia's post-privatization corporate governance challenges are described in Broadman (1999).

The Modern Corporate Form. Generically, there are four key attributes of the modern corporate form worldwide; see Box 2. They enable the enterprise to mobilize and deploy financial and human capital and transform inputs into outputs on a large scale efficiently. The weakness or absence of one or more of the attributes significantly impairs the corporation's efficiency. For example, with limited transferability of ownership interests, the flexibility of owners to reallocate assets to higher-use values is blunted. This would distort the market value of the business, which indicates how well management is performing. Thus, weak transferability would undercut a powerful mechanism that disciplines corporate management to satisfy owners' goals of asset value maintenance and increase.

Operating a large modern corporation inevitably involves the separation of the firm's ownership from its management. The owners select managers to run the firm, and in the process the owners relinquish some of their control as they delegate (some) decision-making to managers. "Corporate governance" refers to the set of relationships that link the ownership and control of an enterprise, the mechanisms through which these relationships are mediated (e.g., monitoring and evaluation controls), and the nature of incentives, risks and constraints that affect how the actions of a firm's owners, managers and workers as well as others (e.g., banks, suppliers and customers) influence the firm's conduct and performance.⁸ The classic problem of the owners is how to structure *internally* the corporate organization and its operations in a manner that provides the proper incentives to managers for the attainment of the owners' goals. At the same time, various *external* incentives discipline the conduct of managers and thus ultimately affect firm performance (see Box 3). International experience suggests that improved business performance depends not only on how well a business implements the four key attributes that comprise the modern corporate form, but also on the dynamic interplay of these internal and external incentives.

Box 2: The Four Structural Attributes of the Modern Corporation

1. **Separate identity.** The corporation is a legal entity distinct from its owners ("shareholders"), with a clear definition of and accounting for its own assets and liabilities;
2. **Limited liability for owners.** Owners' risk of financial loss is limited to their contribution to the corporation's capital;
3. **Centralized role for corporate management and a board of directors.** The day-to-day affairs of the corporation are conducted by one or more persons ("managers"), who are hired by the owners. A board of directors, elected by the owners, represents the owners' interests by giving direction to management and carrying out oversight of managers' performance; and
4. **Transferability of ownership shares.** The shareholders' ownership interests are transferable, and a transfer by an owner does not, in itself, change the rights and obligations of the corporation with respect to its own assets and liabilities.

Source: Broadman (1996)

Principal-Agent Problems. Providing for sound corporate governance is a challenge all modern corporations the world over must meet. It is difficult to ensure that the actions of a firm's managers (the "agents") are consistent with the interests of the firm's owners (the "principals"). When managers do not act in the interest of owners, "principal-agent problems" arise. The extent of this conflict depends on a number of factors, most importantly the extent and quality of information about the activities of the managers. Owners have dealt with the principal-agent problem through a variety of means including: increasing the flow of information made available by managers about their activities; more intense monitoring by owners and others (including banks) of managers' conduct and performance; and

⁸ See Shleifer and Vishny (1997).

implementing mechanisms to better align the interests of managers and owners/shareholders (for example performance contracts, stock options and ownership). Of course, different types of corporate governance systems have been used to solve the principal-agent problem. For example, the United States and the United Kingdom rely heavily on shareholders' actions in stock markets, Japan utilizes a bank-based system and Germany's framework is centered on institutional investors.⁹ There is no obvious ranking as to which of these three, or any other, corporate governance system is best for promoting efficient corporations. But there is a clear consensus worldwide that all of the most successful corporate governance systems are centered on the judicious use of market-based incentives. The OECD has recently devised a set of corporate governance principles that provide a useful guideline.¹⁰

Box 3: Internal and External Incentives Determine Corporate Performance

There are two categories of factors whose dynamic interplay determine the performance of the modern corporation: the "internal" incentive arrangements between owners and managers, and the "external" factors that discipline and monitor the behavior of managers and ultimately the firm's performance. While internal incentives are *necessary* to achieve corporate efficiency, they are *not sufficient*; external incentives must also be manifest.

- (a) **Internal Incentives.** These include the structures and mechanisms by which the owners cause the managers to act for the goals set by the former, i.e., the internal "corporate governance" arrangements. This involves defining how the owners, the board of directors and managers interact with one another to fulfill the owners' objectives. The arrangements stipulate how various decisions will be made and who will be accountable for them. The principal decisions include owners' election of the board of directors, the naming of corporate officers, approval/disapproval of changes to the corporate charter, mergers/ acquisitions, increases and decreases in capital, major debt borrowings, disposal of assets, determination and deployment of retained earnings and dividends, and the setting of managerial pay.
- (b) **External Incentives:** These are factors that are not usually under the direct control of owners (although they can have some indirect influence on them). They include the extent of product market competition (including the ability for the firm to affect market prices and for new competitors to enter and exit the market); the functioning of equity and debt markets (including the effectiveness of the "market for corporate control" and of threats of bankruptcy or liquidation for value-subtracting firms); the corporation's legal obligations, including monitoring of financial accounts through independent audits; and the competitiveness of the labor market (including the market for managerial and entrepreneurial talent).

Source: Broadman (1996).

Associations. In Uzbekistan, as epitomized in the case of the 56 "trade associations"—which dominate key sectors—corporate governance practices are, in general, not fully based on market incentives. It appears there is often little distinction between the role of government as policy maker and regulator, on the one hand, and business shareholder (owner) and manager, on the other. Formerly sector ministries, associations were established in 1992-3 by Presidential Decrees, and have charters approved by the Cabinet of Ministers; typically they are not registered as companies under the Company Law. Although the functions of associations vary from sector to sector, they include lobbying to advance "members'" interests; rationalizing output, pricing, investment, distribution, input, and foreign exchange allocation decisions; and operating akin to holding companies. For three case studies of associations, see Box 4. Figure 1 provides an organizational chart of Uzbekneftegaz, the oil and gas association.

⁹ See Aoki and Kim (1995).

¹⁰ OECD (1999).

Box 4: State "Associations" in Uzbekistan

There are 56 "trade associations" in Uzbekistan. Due to consolidation, the number of associations is decreasing; last year three construction associations were terminated. The following summarizes case studies of 3 associations.

Uzavtotrans (motor transport services): Uzavtotrans was created by Presidential decree in 1993, and was formerly a sector ministry; although it officially bears the name of a "joint stock company", it is not registered under the Company Law. Uzavtotrans is essentially an administrative holding group overseeing 285 firms, of which about 215 are either state owned or joint state-private and 70 are wholly private, including one joint-venture; the number of firms with private shareholding has been increasing, virtually all in the freight area. Uzavtotrans describes its role as serving as "an intermediary between the Government and its member-firms". The firms in the association have approximately 80,000 employees. Uzavtotrans has a 60% market share in passenger transport, and a 25% market share in freight transport. The head of Uzavtotrans has the rank of Minister and he is a member of the Cabinet of Ministers. He is elected by the association's "corporation council"—its board of which he is chairman—and his appointment is approved by the President of Uzbekistan. The corporation council has 121 members, of which "40 are major shareholders." Uzavtotrans does not issue a public annual report; the "minister" reports regularly on the sector's plans and performance to the Cabinet. Firms that are members of Uzavtotrans officially pay a membership fee of 1.5% of their reported profits. The association's budget for 1998 was 380 million Som (US\$ 2.75 million). Uzavtotrans does not directly get involved in foreign exchange transactions with its members. However, Uzavtotrans does directly assist their firms in arranging for bank credits: in fact it arranges for State guarantees for the loans and underwrites the credit risk.

Uzbekneftegaz (petroleum and gas): Uzbekneftegaz is a part of the former ministry for oil and gas, which dates back to the break up of the USSR. Created by a 1992 Presidential decree, it has gone through several re-organizations in the past seven years; Uzbekneftegaz is not registered under the Company Law. Its underlying holdings include 8 directly held entities and 79 indirectly held entities. All entities except for one are reported to be joint-stock companies, with at least 51% state ownership, as exercised through Uzbekneftegaz on the underlying entities' boards; the exception is Uzmil Oil, which is a joint venture between Uzbekistan and Malaysia. In total, the firms employ 83,000 persons. In the upper level holding entity itself, there are 127 employees, and its budget for 1999 is 700 million Som (US\$ 5.1 million); no information was available on the fees collected from its members. Uzbekneftegaz is governed by (i) a supervisory committee, which is chaired by the Prime Minister and includes other ministers, other state representatives, including banks; and (ii) a board of directors, which is comprised of nine senior managers of Uzbekneftegaz. The board reports to the supervisory committee. The head of Uzbekneftegaz has the rank of minister and is a member of the Cabinet of Ministers. Uzbekneftegaz does not issue a public annual report; although the CEO does report quarterly to the Cabinet of Ministers on the association's plans and performance. Uzbekneftegaz oversees and "controls" the production, sales and distribution of the products and services of its underlying entities. For domestic sales that Uzbekneftegaz makes to the Ministry of Energy, prices are regulated by the Ministry of Finance (i.e., the Anti-Monopoly Committee); for international sales, the terms are based on negotiated contracts. Uzbekneftegaz manages the earnings and disposition of foreign exchange for the underlying entities. The association also arranges and provides guarantees for credit extended by banks to its underlying entities; it reports that it has not had a problem in bank loan defaults.

Uzkhlopkopromsbyt (cotton processing and marketing): Uzkhlopkopromsbyt was established by Presidential decree in 1992; it was the Ministry of Cotton Processing. It is not registered under the Company Law. The CEO has the rank of minister and is a member of the Cabinet of Ministers; he is appointed by the Cabinet of Ministers. There are about 130 cotton ginneries as members of Uzkhlopkopromsbyt; each has 3-4 cotton producers associated with them. In total, its member firms employ 60-70,000 persons. All of the ginneries are reported to be joint-stock companies. For the typical ginnery, the state owns 51% of the shares, employees own 26%, and individuals own the remaining shares. For the state shares, Uzkhlopkopromsbyt represents the state on the ginneries' boards. There is a plan for state ownership to decrease to 25%. Uzkhlopkopromsbyt reports that at present it has two main objectives: First, it provides credit to cotton producers from a special fund established by a Presidential decree to finance the annual cotton-picking campaign; producers pay back the credits through selling cotton to Uzkhlopkopromsbyt at predetermined prices, which may or may not contain a premium compared to world prices. Second, Uzkhlopkopromsbyt provides transport and storage services as well as equipment and technical assistance to ginneries. Uzkhlopkopromsbyt does not engage in the export of cotton; it only has the rights to sell to domestic factories (the Ministry of Foreign Economic Relations handles cotton exports). Uzkhlopkopromsbyt was unable to provide information on its budget; the fees it collects are determined by the price premia paid to ginneries, which it estimates as 2% of the price, but it varies across producers. Membership in the association is not obligatory; however, there are no cotton producers that are not in its membership.

Source: Author's interviews

Associations are headed by individuals that have the rank of Minister, serve as members of the Cabinet of Ministers, attend meetings of the Cabinet and regularly report to the Cabinet on the sector's output, production plans, profitability and other indicator's of performance. Some associations have set up their own banks; most have not. Associations are governed by "boards of directors" (or similar groups) comprised of sector 'insiders'. Staff of an association typically serve on the boards of their underlying entities, representing the State's interests on the boards' decisions. While most association members are SOEs, some associations have members that are privatized firms, new private entrants, and foreign joint ventures; however, it is widely perceived that most associations are not in favor of their members being privatized and that they act to forestall such privatizations. It is also widely perceived that associations act to undercut competitively the PIFs; for example by arranging for subsidized credit or energy inputs to create an unlevel playing field. Although in many cases an association may hold less than a 25% share in an underlying entity—the size of share ownership required under the Company Law to block shareholders' decisions—by dint of the association's control over other facets of the sector's operations, it can exercise control over an entity disproportionately to its ownership. Managers of the underlying firms still perceive of the associations as their sector ministries; although the name of their supervisory authority has changed, the firms' managers see no effective change. While membership in an association is not legally mandatory, in practice, virtually every firm operating (or seeking to operate) within a given sector is (or becomes) a member of the sector's association. Estimates vary as to the size of membership fees charged, but they appear to be on the order of 10%-20% of profit.

Corporate governance incentives and structures appear stronger in the private sector. In 1999 there were 84,900 private firms in Uzbekistan; as noted earlier, this accounts for about 45 percent of the total number of registered firms in the country. Most of these firms are of small and medium size; relative few are corporations under the Company Law. Improvements in corporate governance are most pronounced in the PIFs. But these entities are not yet of sufficient scale in the economy to effect fundamental behavioral changes in business practices, nor induce systemic competition economy-wide. Indeed the role of the PIFs appears to be on the decline, in part because of the continued dominance of the trade associations.

Separating Government from Business. Enhancing corporate governance practices in Uzbekistan can come about through several related reforms. First, in order to engender real separation between government and business—a critical objective for clarity of corporate governance incentives—the 56 "associations" should undergo fundamental reorganization and reform. This would include (i) their corporatization and becoming *bona fide* commercial companies—under the strictures of the Company Law. In other transition economies where SOEs have been corporatized, there has been improved enterprise performance. At the same time, (ii) the associations should employ 'outsiders' and non-State, non-government representatives on their boards of directors and in senior management positions, including but not limited to, the chief executives. Heads of associations would no longer serve as "ministers", sit on the Cabinet of Ministers, nor have membership in the Government. And, in time, (iii) the State should divest of its ownership shares in all but a very select few associations, essentially (a) those where there are *bona fide* natural monopoly structures (see below) and (b) *bona fide* military or national security activities. If the Government is indeed interested in compelling a stronger competitive environment for private business development in Uzbekistan, continued State ownership on the scale that currently exists in the associations will be highly problematic. At a minimum, the Government will need to come to the realization that if it is interested in enhancing the use-value of State assets, there is a very strong case for reducing State ownership to a passive, minority position and providing for professional independent managers to serve as custodians and control association enterprise operations.

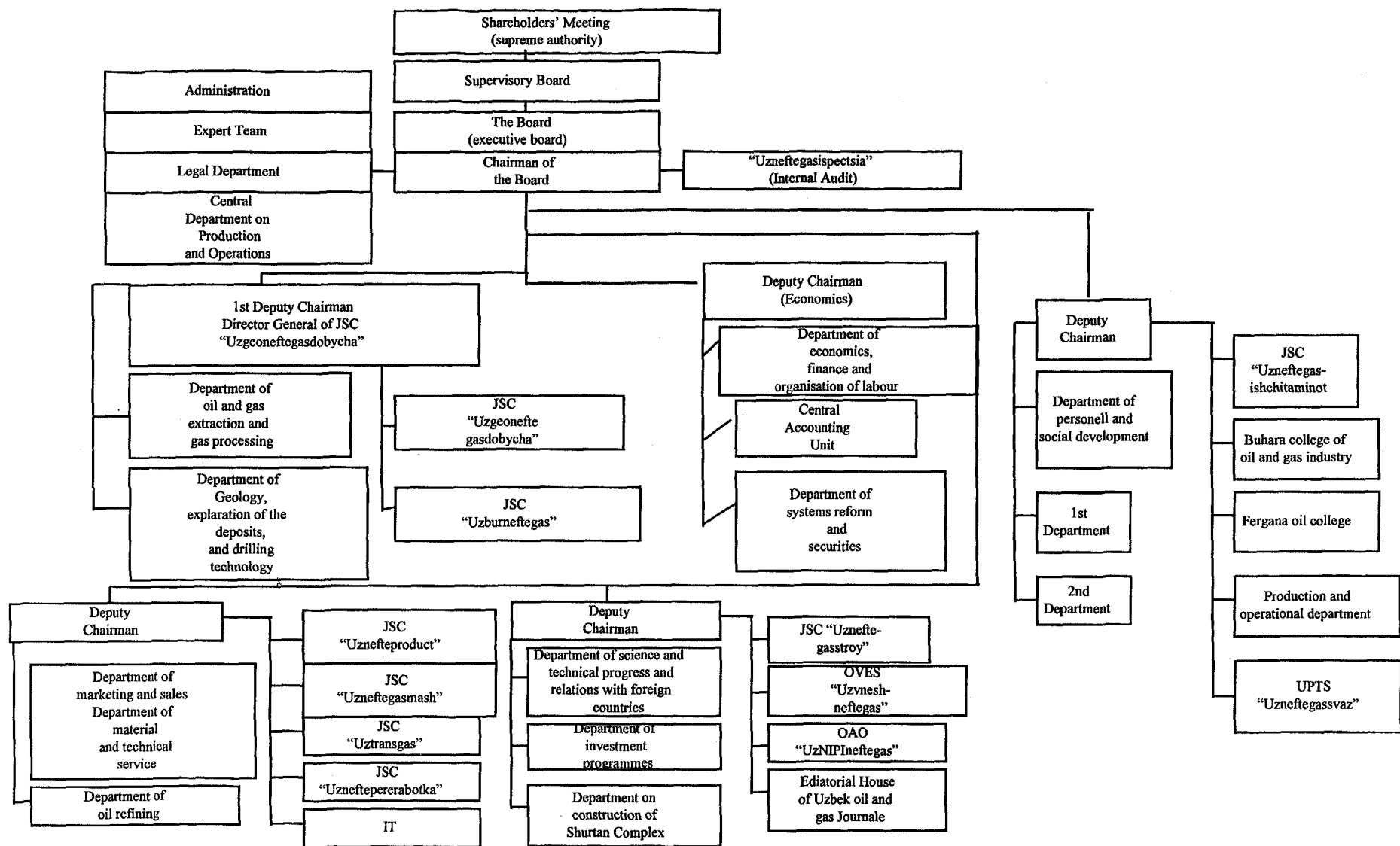


Figure 1: Organizational Chart of Uzbekneftegaz

Simplifying Holding Company/Group Structures. Second, simplification, rationalization and competitive restructuring of holding group structures should also be carried out. In the associations where such holding company-type structures exist, they appear (relative to international practice) to be not only unduly complex and non-transparent—thus making the task of utilizing internal control mechanisms for effective information gathering/monitoring of management and employee activities difficult—but arguably are also not structured to maximize economies of scale and scope, thus engendering increased operational and production costs and undermining competitiveness. Different associations will require different types of simplification, rationalization and restructuring, and there is no uniform model that should be implemented. Carrying out the two reforms indicated above will help reorient the incentives to those who should be in a better position than is currently the case for deciding what type of restructuring makes the best commercial sense.

Fostering Competitive Rivalry. Third, by the same token, stronger external competitive discipline on the associations will also help compel the restructuring that is desirable. In part, this means following through with the other reforms suggested in the sections above for improving the overall competitive environment in Uzbekistan. This should help encourage new private business entry and provide for a more fertile environment for PIFs to challenge the market domain of the associations. The example set by China of allowing non-state firms to challenge SOEs is instructive in this regard.¹¹ But it also means that other external checks and balances need to be put in place. In particular, commercial and risk-based banking and financial sector practices are required to exert effective credit and debt collection discipline on business performance. Similarly, application of international accounting standards (IAS) and published regular audits of such financial accounts carried out by independent auditors will also be essential.

VII. COMPETITIVE RESTRUCTURING AND REFORM OF INFRASTRUCTURE MONOPOLIES

Like other transition economies, Uzbekistan has adopted the nomenclature of “natural monopolies” for specific sectors of the economy—those that typically encompass large firms that provide infrastructure services on a public, economy-wide basis, i.e., services that are either basic inputs to other businesses or basic provisions for the livelihood of households. Rooted in the earlier Soviet regime, the designations of many such monopolies as “natural” have less to do with the true economic structure of markets than with previous notions of command and control and central planning, as enshrined in statutory criteria.

Under Uzbekistan law—for example, the law “On Competition and Restriction of Monopoly Activity in Commodity Markets”—at least the following sectors are formally defined as “natural monopolies”: (i) production of oil, gas condensate and natural gas; (ii) coal mining; (iii) pipeline transport of oil, refined petroleum and natural gas; (iv) generation, transmission and distribution of electric power and heat; (v) railway transport; (vi) port services; (vii) airport services; (viii) telecommunications; (ix) postal services; and (x) water supply and sewage. Table 2 indicates the number of “natural monopoly” suppliers in each sector as indicated by the Anti-Monopoly Committee as of October 1999.

¹¹ See Broadman (1999).

**Table 2: Uzbekistan Enterprises Registered as “Natural Monopolies” at the Republic Level
(as of October 1, 1999)**

Sectors with “Natural Monopolies”	Number of Enterprises
Production of oil, gas condensate and natural gas	7
Coal mining	4
Pipeline transport of oil	1
Pipeline transport of natural gas	2
Generation, transmission and distribution of electric power and heat	48
Railway transport	1
Airport services	12
Postal services	16
Telecommunications	21
Water and sewage	30
Total	142

Source: Uzbekistan Anti-Monopoly Committee

When Monopolies are No Longer “Natural”. International experience shows that policies that stifle the operation of inherently competitive infrastructure sectors, as well as prevent the progression of traditional “natural” monopolies into more competitive regimes, impose costs on society in the form of high consumer prices, poor production efficiency and retarded innovation. Distinguishing between competitive versus noncompetitive infrastructure sectors is thus an important policy issue in designing further transition reform initiatives. In this regard, governments worldwide typically categorize public enterprises into three groups, and this taxonomy provides a useful guide for Uzbekistan policymakers: (a) in “strategic” industries—the national military defense sector, the currency mint, and the mining of rare metals that have national defense applications—there is, with few exceptions, a compelling rationale for state involvement; (b) in “monopoly or quasi-monopoly” industries—usually local-level utilities in the energy, mass transit and communication sectors—the rationale for government involvement, either through direct ownership or regulatory oversight of nonstate-owned service providers, has historically been strong inasmuch as market forces alone can often produce suboptimal results; however, such sectors can evolve to a point where the competitive provision of such services is most efficient, and this outcome has often entailed the divestiture of utility firms to private owners; and (c) in “commercial” industries—most of the manufacturing and services sectors—there is generally little justification for state involvement, as competitive market forces often engender the greatest efficiencies.

The overwhelming majority of industrial sectors in countries around the world today possess underlying organizational structures that are *inherently* competitive. Thus within the typical industrial sector, maximum social efficiency is realized when numerous firms are producing the product (or service); the output share of each firm is not large enough to control the prevailing price in the market; any attempt by a firm to charge an above-market price will produce a loss of consumers or entry by rival

firms eroding any temporary excess profits; and prolonged losses of poorly performing firms will bring on a change of management, a buy-out by new owners, exit or liquidation of the firm. In such “naturally” competitive sectors, artificially restricting the number of firms or output through government intervention, such as by establishing policy barriers to entry or exit, burdensome registration or licensing requirements, or international tariffs and quotas, raises consumer prices, reduces productive efficiency of the firms, and stifles innovation. Society is thus made worse off.

In contrast, there are a limited number of other sectors where society benefits from fewer firms. These “natural” monopoly (or oligopoly) sectors have a special characteristic unique to the product (or service) they are producing, often due to industry-specific technologies: as production expands, the average cost of producing each additional unit declines. In such special situations, it is most efficient to let one or a few firms produce as much as the market demands; indeed too many firms all trying to take advantage of the sector’s inherent economies of scale will result in uneconomic duplication of facilities and chronic losses. This raises the question: doesn’t allowing only one or a few firms to operate in a market simply invite them to take advantage of the opportunity to set prices too high? There are two answers. In some cases, the best solution is to give the firms *exclusive* market franchises *in return* for subjecting their price-setting or profits to regulation. In other cases, the cost of entry and exit by rival firms is relatively low. As a result, the credible threat posed by *potential* competitors exerts a sufficiently strong discipline on the incumbent firm (or firms) to keep prices at competitive levels; these are sometimes referred to as “contestable” markets.

Worldwide, the inherently competitive sectors generally encompass all of manufacturing and many natural resource and services industries; this includes, for example, chemicals; steel; machinery; automobile production; textiles; electronics; oil, gas and coal; and construction. Some utility service industries possess organizational structures that are naturally monopolistic (or oligopolistic). Underground pipeline distribution of natural gas at the city level to residential consumers is a good example; universally, such firms are given market franchises and subjected to regulation. But economic history teaches that many industries thought to be natural monopolies actually go through life cycles; as they mature, technology advances and markets grow, they *evolve* into competitive sectors. Whereas long distance telecommunications or postal services previously were considered “natural” monopolies, today they are inherently competitively structured. The airline industry has also evolved into a contestable sector. Putting in place government policies that either prevent such an evolution or maintain artificial monopolies can inflict sizable costs on society in terms of increased prices; lost output; poor service quality; and reduced innovation.

Competitive Unbundling and Restructuring. These lessons suggest several reform items for Uzbekistan. The first is the need for proactive restructuring and unbundling in state owned infrastructure market segments where (i) monopoly structures are not, or are no longer, “natural” and (ii) the (deregulated) private, competitive provision of utility services with open entry will enhance economic welfare. Sectors where such reforms are most needed likely include coal mining, oil and natural gas production, telecommunications, electric generation and transmission, railways and other forms of long-haul transport, airport services, and postal services. The draft *Program of Formation of a Competitive Environment for 2000-2005* recently tabled with the Cabinet of Ministers too modestly begins to address some of these objectives. The sectoral spread covered in the Program is far too narrow. Moreover, the Program foresees maintenance of price controls on such sectors, where not only should there be entry deregulation but also price deregulation.

Privatization and Competitive Entry. Second, there should be plans developed for the privatization of these entities, utilizing international best practice transparent and competitive case-by-case privatization techniques with the assistance of independent financial advisors. The objective should be to attract new private strategic investors to enhance the operational efficiency of the entities sold.

However, privatization of these infrastructure monopolies should not precede the establishment of effective competition policy and regulatory disciplines so as to prevent simply shifting a public monopoly to a private monopoly.

Regulatory Reform. Third, in the remaining infrastructure monopoly market segments, reforms of regulatory institutions and oversight procedures are needed to bring Uzbekistan's regulatory regime in line with international practice. Indeed this is also an objective on the agenda of the Anti-Monopoly Committee. Specifically actions are needed in this regard along several fronts:

- De-politicization of tariff-setting, entry/exit decisions, service offerings and implementation of other regulatory mechanisms. In part, this will come about through the restructuring of the Anti-Monopoly Committee into as independent agency as suggested above. Use of independent regulators and judges (where necessary) is critical to ensuring impartiality of regulatory decisions. The term/tenure of regulatory officials should be made immune from the political process/cycle.
- Reduction of discretionary behavior in implementing regulations. Achieving this objective will necessitate strengthening the legislation that defines the rules-based regime and enforcing incentives/disincentives for officials to adopt stricter adherence to that regime. Streamlining the decision-making process will also reduce opportunities for discretionary conduct by regulators.
- The content of the regulations should ensure that price, output and investment decisions by service suppliers are both in line with costs and pro-competitive, i.e., that they create a "level playing field" among users so as to not provide for cross-subsidies and unfair advantages, especially between SOEs and private firms.
- Safeguards should be put in place that increase the public transparency and accountability of regulatory decisions. This can be accomplished through regular public hearings where all affected interests can participate, including the regulated entities, their business and residential consumers, workers and the general public. There should also be a transparent appeals process for businesses and consumers who wish to question decisions that have been undertaken.

VIII. CONCLUSION AND SUMMARY

The preceding analysis suggested several areas where Uzbekistan should focus its structural reform agenda in order to enhance the country's enabling environment for business development and growth. It is clear that a better understanding of, and appreciation for the benefits of enterprise competition and how it influences economic growth are needed among senior policy makers, businesses (including banks and the privatization investment funds (PIFs)), and consumers. This can be fostered through better training of officials on the concepts of competition and regulation; use of on-the-ground policy advisors that can bring to bear international experience in implementing competition and regulatory reform policies, including improving the legislative framework; and greater public education through, for example, the creation of non-governmental organizations (NGOs) to communicate the benefits of competition and possibly serve as an ombudsman for consumer rights.

Reform of Uzbekistan's competition policy framework should be devised and implemented within the broader context of the Government's goal of strengthening the overall structural reform program; it should also be linked with the country's macroeconomic policy objectives. Formulation of policies to enhance the business environment should focus not only on fostering the competitive conduct of incumbent firms, but also on (i) reducing barriers to entry by new firms—usually the engines of growth

and employment creation in transition economies and (ii) reducing fiscal and financial system business subsidies—"hardening budget constraints"—and facilitating the restructuring, reorganization and bankruptcy, including where necessary liquidation, of inefficient firms so as to re-channel bottled up assets to new ventures. At the same time, the industrial policy regime should be reformed to be made consistent with the objectives of the country's competition policy. Similarly, reforms in the areas of foreign exchange liberalization, international trade and direct investment, fiscal and financial sector policy should be informed by, and harmonized with those aimed at improving the competitive business environment.

The analytical capabilities of Governmental and associated institutions also need to be considerably enhanced to carry out on a systematic and regular basis and in line with international practice, independent economic assessments of Uzbekistan's industrial market structure and determinants of enterprise conduct and performance. To date, only a handful of major analyses of Uzbekistan's industrial structure has been undertaken; and most have been on a sectoral basis. Moreover they have generally focused on the narrow issues of competition as defined by current statutes, such as legally defined market shares. Rather, what is needed to inform effectively Government competition policy-making consistent with promoting the public interest are: (i) comprehensive independent assessments of product and geographic market boundaries, as determined by economic forces so as to accurately gauge market structures; (ii) analysis of how the structure of markets (e.g., extent of producer concentration and barrier to entry) influences business performance and economic welfare; and a focus on not only specific sectors but also on cross-sectoral market structures, such as horizontal and vertical integration.

In order to create a credible competition "champion"—one with teeth—within the Government, the organization, structure and functions of the existing authority responsible for competition and regulatory policy-making and enforcement should be transformed into an independent agency, reporting directly to the Prime Minister. The current Anti-Monopoly Committee is an outgrowth from the earlier Committee on Prices (hence its reliance on price controls as a competition policy instrument), and is part of the Ministry of Finance, with a Deputy Finance Minister serving as its Chairman. To effect greater public commitment to implement competition policy in a de-politicized fashion, reduce apparent conflicts of interest, and have the clout to deal with powerful vested interests, both on an inter-agency basis and within the economy at the republic and local levels, there is a need to break from the past and reinvigorate the agency with a new mandate and "corporate culture". There is not a single model for restructuring of the agency, but international practice suggests a set of principles upon which the agency should operate, including, but not limited to: decisions should be rules-based; the entity's budget should be financially autonomous from other ministries; there should be a transparent appeals process for consumers and businesses, including public hearings; the agency should have autonomous legislative authority; and the agency's performance should be subject to regular public monitoring to ensure the public interest is protected.

Corporate governance incentives and institutions should be strengthened and brought in line with market-based principles and international practice (for example, the new OECD corporate governance guidelines) to engender greater transparency and accountability. Currently, sound corporate governance practices are blunted because of ill-defined organizational structures and institutions, contradictory lines of authority, and weak disciplines/checks and balances, especially in the management of State assets. As epitomized in the case of the 56 "trade associations", it appears there is often little distinction between the role of government as policy maker and regulator, on the one hand, and business shareholder (owner) and manager, on the other: as former sector ministries, these holding group entities bear little resemblance to *bona fide* companies, are still headed by individuals that serve on the Cabinet of Ministers, and are governed by boards of directors comprised of 'insiders'. Corporate governance incentives and structures appear stronger in the nascent private sector, especially the PIFs, but these entities are not yet of sufficient competitive scale in the economy to effect fundamental behavioral changes; indeed the role of the PIFs

appears to be on the decline, despite the growing private sector. Generally, enhanced corporate governance could be brought about through (i) corporatization (under the company law), privatization/divestiture and competitive restructuring of “associations” in order to engender real separation of government from business; (ii) use of outsiders and non-state representatives on boards of directors and senior management; (iii) commercial and risk-based banking and financial sector practices that exert effective credit discipline on business performance; and (iv) application of international accounting standards and published regular audits of financial accounts carried out by independent auditors.

Finally, infrastructure monopolies should be subject to systemic restructuring and unbundling in market segments where monopoly structures are not, or are no longer, “natural” and the (deregulated) private, competitive provision of utility services with open entry enhances economic welfare. In the remaining infrastructure monopoly market segments, reform of regulatory institutions and oversight procedures is needed to de-politicize tariff setting and implementation of other regulatory mechanisms; ensure that price, output and investment decisions by service suppliers are pro-competitive (i.e., create a “level playing field” among users); and increase public transparency and accountability. The plethora of so-called “natural monopolies” in Uzbekistan stems less from application of economic criteria than of old style statutory designations; with the development and expansion of markets, as well as advances in technologies, increasing types of utility services, such as telecommunications and electric generation (among others), when provided through competitive multiple suppliers, rather than protected single suppliers, offer the best chances for cost-based prices, high service quality and reliability, and innovation. In most utility segments, then, the bias should shift towards regulation by market forces rather than by administrative means; however, privatization of infrastructure monopolies should not precede establishment of effective competition policy and regulatory disciplines so as to prevent simply shifting a public monopoly to a private monopoly. Reform of regulatory mechanisms should be keyed to strengthening and streamlining the rules-based framework; enhancing safeguards to ensure that decisions regarding rate-making and service offerings are impartial and independent; providing for the tenure of regulatory officials to be immune from the political process; establishing a transparent appeals process for consumers and businesses, including public hearings.

BIBLIOGRAPHY

- AMCHAM Uzbekistan (1999). "Recommendations for Improved Foreign Investment Conditions in the Republic of Uzbekistan," American Chamber of Commerce in Uzbekistan, Tashkent.
- Aoki, M. and Kim, H.K., eds. (1995) *Corporate Governance in Transitional Economies*, The World Bank, Washington, DC.
- Broadman, H. ed. (1996) *Policy Options for Reform of Chinese State-Owned Enterprises*, The World Bank, Washington, DC.
- Broadman, H. (1999) "The Chinese State as Corporate Shareholder," *Finance and Development*, Volume 36, Number 3, pp.52-55.
- Broadman, H. (2000) "Reducing Structural Dominance and Entry Barriers in Russian Industry," *The Review of Industrial Organization* (in press).
- Bergsman J., Broadman H. and Drebenstov V. (1999), "Improving Russia's Foreign Direct Investment Policy Regime," in Broadman, H. ed. (1999) *Russian Trade Policy Reform for WTO Accession*, The World Bank, Washington, DC.
- Frye, T. and Shliefer, A. (1996) "The Invisible and Grabbing Hand," NBER Working Paper 5856.
- Gray, C., and Kaufmann, D. (1998) "Corruption and Development," *Finance and Development*, March.
- Karimov, I. (1998). *Uzbekistan on the Threshold of the Twenty First Century*. St. Martin's Press, New York
- OECD (1999) *OECD Principles of Corporate Governance*, OECD, Paris.
- Shleifer, A. and Vishny, R. (1997) "A Survey of Corporate Governance", *Journal of Finance*. 52: 737-783
- LaFleur, J. (1999) "Questionnaire to Improve the Legal and Regulatory Enabling Environment for Small and Medium Businesses in Uzbekistan." USAID
- World Bank (1995), *Bureaucrats in Business*, a World Bank Policy Research Report, Oxford University Press, New York, 1995.
- World Bank (1997) *China's Management of Enterprise Assets*, The World Bank, Washington, DC.
- World Bank (1999) *Uzbekistan: Social and Structural Policy Review*, The World Bank, Washington, DC.
- Zettelmeyer, J. (1998). "The Uzbek Growth Puzzle," *IMF Working Paper* No. WP/98/133, Washington, DC.

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS2314	Technological Leadership and Foreign Investors' Choice of Entry Mode	Beata K. Smarzynska	April 2000	L. Tabada 36896
WPS2315	Investment in Natural Gas Pipelines in the Southern Cone of Latin America	Alejandro Jadresic	April 2000	M. Salehi 37157
WPS2316	Distributional Outcomes of a Decentralized Welfare Program	Emanuela Galasso Martin Ravallion	April 2000	P. Sader 33902
WPS2317	Trade Negotiations in the Presence of Network Externalities	Keiko Kubota	April 2000	L. Tabada 36896
WPS2318	Regulatory Reform, Competition, and Innovation: A Case Study of the Mexican Road Freight Industry	Mark A. Dutz Aydin Hayri Pablo Ibarra	April 2000	H. Sladovich 37698
WPS2319	Externalities and Production Efficiency	Gunnar S. Eskeland	April 2000	H. Sladovich 37698
WPS2320	Does More Intense Competition Lead to Higher Growth?	Mark A. Dutz Aydin Hayri	April 2000	H. Sladovich 37698
WPS2321	Algorithms for Purchasing AIDS Vaccines	David Bishai Maria K. Lin C. W. B. Kiyonga	April 2000	P. Sader 33902
WPS2322	Self-Targeted Subsidies: The Distributional Impact of the Egyptian Food Subsidy System	Richard H. Acams, Jr.	April 2000	M. Coleridge-Taylor 33704
WPS2323	Globalization and Firms' Financing Choices: Evidence from Emerging Economies	Sergio Schmukler Esteban Vesperoni	April 2000	E. Khine 37471
WPS2324	Give Growth and Macroeconomic Stability in Russia a Chance: Harden Budgets by Eliminating Nonpayments	Brian Pinto Vladimir Drebenstov Alexander Morozov	April 2000	H. Makarenko 87832
WPS2325	Banking Systems Around the Globe: Do Regulation and Ownership Affect Performance and Stability?	James R. Barth Gerard Caprio, Jr. Ross Levine	April 2000	A. Yaptenco 31823
WPS2326	How Urban Concentration Affects Economic Growth	Vernon Henderson	April 2000	R. Yazigi 37176
WPS2327	How the Republic of Korea's Financial Structure Affects the Volatility of Four Asset Prices	Hong G. Min Jong-goo Park	April 2000	P. Rathana-Raj 33705

Policy Research Working Paper Series

Title	Author	Date	Contact for paper
WPS2328 Social Transfers and Social Assistance: An Empirical Analysis Using Latvian Household Survey Data	Branko Milanovic	April 2000	P. Sader 33902
WPS2329 Improving Russia's Policy on Foreign Direct Investment	Joel Bergsman Harry G. Broadman Vladimir Drebentsov	May 2000	S. Craig 33160
WPS2330 Reducing Structural Dominance and Entry Barriers in Russian Industry	Harry G. Broadman	May 2000	S. Craig 33160